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MAXIMIZING TAX BENEFITS TO FARMERS AND RANCHERS IMPLEMENTING CONSERVATION AND ENVIRONMENTAL PLANS

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I. Introduction

As the implementation of sound conservation and environmental measures gains importance, farmers and ranchers search for ways to ensure that these measures yield tangible as well as intangible benefits. Federal, state, and local laws provide tax benefits for farmers and ranchers implementing conservation and environmental plans in certain circumstances. Although many commentators focus on the federal income tax benefits of these conservation and environmental plans, such plans may also yield state income tax, federal estate tax, and local real property tax benefits.

Federal, state, and local provisions providing tax benefits for conservation and environmental measures also tend to blur the distinction between "conservation" and "preservation." Often farmers and ranchers need only continue their operations in their present form to reap tax benefits. However, the grantor of the benefits often extracts the promise to continue the farm or ranch activity in perpetuity.

Conservation easements consist of legal agreements which restrict the type and amount of development which may take place on a particular piece of real property.¹ Most literature discussing tax benefits of conservation and environmental plans focuses on these conservation easements. Since conservation easements potentially provide the maximum tax benefits, this article analyzes the various aspects of these conservation easements. However, many farmers and ranchers are unable to utilize the income tax benefits of conservation easements.² Therefore, this article also will provide an overview of alternative valuation for estate tax purposes under section 2032A of the Internal Revenue Code (the Code) and the benefits these options may provide in exchange for preservation of farm land. This article then compares conservation easements with the section 2032A provisions

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1. JANET DIEHL & THOMAS S. BARTON, *THE CONSERVATION EASEMENT HANDBOOK* 5 (1988).

2. See *supra* parts II.D.2., II.I., IV.

and illustrates the situation in which each is the appropriate choice for the farmer or rancher. Finally, this article briefly discusses several other possible tax benefits of conservation and environmental plans.

II. Conservation Easements

A. Introduction

The Code treats certain "qualified conservation contributions" as charitable contributions.³ As charitable contributions, the donor is entitled to take a deduction for income tax purposes. Properly drafted conservation easements qualify for a charitable contribution deduction under this provision.

This section of the article presents an overview of the Code provisions pertaining to conservation easements and the charitable contribution deduction allowed if certain requirements are met. This section also reviews possible estate tax and local real property tax benefits arising from donations of conservation easements and discusses practical drafting considerations.

B. Federal Statute and Regulations

1. Generally

Under section 170(h) of the Code, a deduction for income tax purposes is permitted for contributions of certain partial interests in real property if designated for conservation purposes. The Code requires that a "qualified conservation contribution" satisfies the definition found in section 170(h) to qualify for the deduction.⁴ "Qualified conservation contribution" means a contribution of a "qualified real property interest" ⁵ to a "qualified organization" ⁶ exclusively for "conservation purposes."

A "qualified real property interest" includes a restriction (granted in perpetuity) on the use which may be made of the real property.⁷ A properly drafted conservation easement may constitute a qualified real property interest. Four categories of organizations suffice as qualified organizations to receive the gift of the conservation easement: (a) a governmental unit described in section 170(b)(1)(A)(v) of the Code; (b) a publicly supported charitable organization described in section 170(b)(1)(A)(vi) of the Code; (c) a publicly supported charitable organization described in section 509(a)(2) of the code; and (d) a support organization described in section 509(a)(3) of the Code which is controlled by a governmental unit or publicly supported charitable organization.⁸

Most pertinent to this discussion, "conservation purpose" includes the preservation of open space (including farm land and forest land) where such preservation

3. I.R.C. § 170 (1994).

4. *Id.* § 170(f)(3)(B)(iii).

5. *Id.* § 170(h)(1)(A).

6. *Id.* § 170(h)(1)(B).

7. *Id.* § 170(h)(2)(C).

8. *Id.* § 170(h)(3).

is: (1) for the scenic enjoyment of the general public, or (2) pursuant to a clearly delineated federal, state, or local governmental conservation policy, and will yield a significant public benefit, or (3) for the preservation of a historically land area or a certified historic structure,⁹ or (4) for the protection of a natural habitat of fish, wildlife, or plants, or similar ecosystem.¹⁰

A donation fails to be exclusively for conservation purposes unless the conservation purposes are protected in perpetuity.¹¹ The instrument of conveyance must prohibit the donee from subsequently transferring the easement unless the donee organization, as a condition of the subsequent transfer, requires the continuation of the conservation purposes for which the contribution was originally intended.¹² Subsequent transfers must also be restricted to organizations qualifying as an eligible donee at the time of the subsequent transfer.¹³

If a later unexpected change in conditions makes impossible or impractical the continued use of the subject property for conservation purposes, the instrument must require the property to be sold or exchanged.¹⁴ Any proceeds from the sale must be used by the donee organization in a manner consistent with the conservation purposes of the original contribution.¹⁵

2. Farm and Ranch Land as Open Space

"Preservation of open space," which includes farm land and forest land, provides the conservation purpose most suited for use by farmers and ranchers. Farm land and ranch land most often qualifies "as 'open space' pursuant to a clearly delineated federal, state, or local governmental conservation policy and yielding a significant public benefit" (the clearly delineated policy provision). A general declaration of conservation goals by a single official or legislative body fails to suffice as a clearly delineated policy.¹⁶ However, the governmental policy need not identify particular lots or parcels of individually owned property.¹⁷ Donations that further a specific, identified conservation project, such as the preservation of farm land pursuant to a state program for flood prevention and control, meet the clearly delineated policy requirement.¹⁸

The program implementing the policy need not be funded, but the program must involve a significant commitment by the government with respect to the conservation project.¹⁹ A governmental program according preferential tax assessment or

9. *Id.* § 170(h)(4)(A)(iii). Note that conservation purpose also includes the preservation of land areas for outdoor recreation by or the education of, the general public. *See id.* § 107(h)(4)(A)(i).

10. *Id.* § 170(h)(4)(A)(ii).

11. *Id.* § 170(h)(5)(A).

12. Treas. Reg. § 1.170A-14(c)(2) (as amended 1988).

13. *Id.*

14. *Id.*

15. *Id.*

16. *Id.* § 1.170A-14(d)(4)(iii)(A).

17. *Id.*

18. *Id.*

19. *Id.*

preferential zoning for certain property deemed worthy of protection for conservation purposes constitutes a significant commitment by the government.²⁰ Acceptance of an easement by an agency of the federal, state or local government tends to establish the clearly delineated policy. However, acceptance, without more, is not sufficient.²¹

Most importantly, the donor is not required to allow public access to the property subject to a donation under the clearly delineated conservation policy provision to receive treatment as a charitable contribution (unless the conservation purpose of the donation would be undermined or frustrated without public access).²² In contrast, to qualify under the "scenic enjoyment of the general public" provision for preservation of open space, the public must be afforded access to the property, although visual access may suffice.²³

The regulations list eleven nonexclusive factors to consider in determining whether significant public benefit derives from the conservation contribution: (a) the uniqueness of the property to the area; (b) the intensity of land development in the vicinity of the property (both existing and foreseeable); (c) the consistency of the proposed open space use with public programs for conservation in the region; (d) the consistency of the proposed open space use with existing private conservation programs in the area; (e) the likelihood that development of the property would lead to or contribute the degradation of the scenic, natural or historic character of the area; (f) the opportunity for the general public to use the property or to appreciate its scenic value; (g) the importance of the property in preserving a local or regional landscape or resource that attracts tourism or commerce to the area; (h) the likelihood that the donee will acquire equally desirable and valuable substitute property or property rights; (i) the costs to the donee of enforcing the terms of the conservation restriction; (j) the population density in the area of the property; and, (k) the consistency of the proposed open space use with a legislatively mandated program identifying particular parcels of land for future protection.²⁴

A donation must be exclusively for conservation purposes to qualify as a charitable deduction.²⁵ However, a donor may derive incidental benefits as a result of the conservation restrictions limiting use without tainting the donation.²⁶ An example from the regulations applies this rule to an agricultural situation:

A qualified conservation organization owns Greenacre in fee as a nature preserve. Greenacre contains a high quality example of a tall grass prairie ecosystem. Farmacre, an operating farm, adjoins Greenacre and is a compatible buffer to the nature preserve. Conver-

20. *Id.*

21. Treas. Reg. § 1.170A-14(d)(4)(iii)(B) (as amended 1988).

22. *Id.* § 170A-14(d)(4)(iii)(C).

23. *Id.* § 1.170A-14(d)(4)(ii)(B).

24. *Id.* § 1.170A-14(d)(4)(iv)(A).

25. *Id.* §§ 1.170A-14(c)(1), 1.170A-14(g)(1)-(g)(6)(ii).

26. *Id.* § 1.170A-14(e)(1).

sion of Farmacre to a more intense use, such as a housing development, would adversely affect the continued use of Greenacre as a nature preserve because of human traffic generated by the development. The owner of Farmacre donates an easement preventing any future development on Farmacre to a qualified conservation organization for conservation purposes. Normal agricultural uses will be allowed on Farmacre. Accordingly, the donation qualifies for a deduction under this section.²⁷

The following is another example from the regulations illustrating the application of the conservation easement rules to the agricultural situation:

In order to protect State S's declining open space that is suited for agricultural use from increasing development pressure that has led to a marked decline in such open space, the Legislature of State S passed a statute authorizing the purchase of "agricultural land development rights" on open acreage. Agricultural land development rights allow the State to place agricultural preservation restrictions on land designated as worthy of protection in order to preserve open space and farm resources. Agricultural preservation restrictions prohibit or limit construction or placement of buildings except those used for agricultural purposes or dwellings used for family living by the farmer and his family and employees; removal of mineral substances in any manner that adversely affects the land's agricultural potential; or other uses detrimental to retention of the land for agricultural use. Money has been appropriated for this program and some landowners have in fact sold their "agricultural land development rights" to State S. K owns and operates a small dairy farm in State S located in an area designated by the Legislature as worthy of protection. K desires to preserve his farm for agricultural purposes in perpetuity. Rather than selling the development rights to State S, K grants to a qualified organization an agricultural preservation restriction on his property in the form of a conservation easement. K reserves to himself, his heirs and assigns the right to manage the farm consistent with sound agricultural and management practices. The preservation of K's land is pursuant to a clearly delineated governmental policy of preserving open space available for agricultural use, and will yield a significant public benefit by preserving open space against increasing development pressures. Accordingly, a deduction is allowed under this section.²⁸

Some commentators believe that all agricultural easements automatically qualify as a qualified conservation contribution.²⁹ They argue that the statute's definition

27. *Id.* § 1.170A-14(f), example (2).

28. *Id.* § 1.170A-14(f), example (5).

29. Vivian Quinn, *Preserving Farm Land with Conservation Easements: Public Benefit or Burden?*, in 1992/1993 ANNUAL SURVEY OF AMERICAN LAW 235, 249 (1994).

of "conservation" implies the purpose of preserving farmland "for farmland's sake."³⁰ The inclusion of the parenthetical "including farmland and forest land" in the statute supports this argument.³¹

Others believe that agricultural easements should be viewed like any other easement under the law.³² The dispute centers upon the difference between "conservation" and "preservation." The Code and regulations fail to acknowledge the difference between the two when identifying "open space" as qualifying for the deduction. Whether the regulations allow mere "preservation" of farmland to qualify for the charitable deduction remains an open question. However, if the state legislature enacts statutes promoting the preservation of farmland, this author believes that conservation easements on agricultural property will certainly qualify for the deduction.³³

3. Internal Revenue Service Rulings on Agricultural Easements

Early Internal Revenue Service (IRS) rulings favored taxpayers who made agricultural conservation easement donations pursuant to a delineated government policy and in an area under significant development pressure.³⁴ A 1986 private letter ruling from the Internal Revenue Service identified four factors which demonstrated the existence of a "significant public benefit" for a proposed agricultural conservation easement.³⁵ The Internal Revenue Service found that: (a) the conservation easement's proposed use and restrictions comported with the existing zoning of the area; (b) the proposed conservation easement fell within a legislatively mandated program identifying particular parcels of land for future protection; (c) the state deemed the property "unique," because it bordered on the county's ninth most densely populated municipality and . . . both a major collector road and a local access road; and, (d) the property's proximity to the suburbs made it subject to development pressure.³⁶

Other private letter rulings also rely on findings of "pressure from development" to qualify an agricultural easement donation.³⁷ Another 1986 ruling considered the prospect of an imminent ninety-seven-unit townhouse project nearby as a relevant factor.³⁸ The Internal Revenue Service also considered significant that at the time

30. *Id.*

31. *Id.*; STEVEN J. SMALL, *THE FEDERAL TAX LAW OF CONSERVATION EASEMENTS* 6-4 n.66 (1990).

32. *Id.*

33. *See infra* part II.E.

34. Quinn, *supra* note 30, at 252; Justin R. Ward & F. Kaid Benfield, *Conservation Easements: Prospects for Sustainable Agriculture*, 8 VA. ENVTL. L.J. 271, 277 (1989).

35. Priv. Ltr. Rul. 86-23-037 (Mar. 11, 1986).

36. *Id.*

37. Priv. Ltr. Rul. 87-11-054 (Dec. 15, 1986) (donation of remainder of farm which had previously been donated as a conservation easement); Priv. Ltr. Rul. 86-38-012 (June 18, 1986) (cattle ranch); Priv. Ltr. Rul. 85-44-036 (Aug. 1, 1985) (dairy farm); Priv. Ltr. Rul. 85-18-024 (Jan. 31, 1985) (504-acre farm adjacent to a historic preservation site); Priv. Ltr. Rul. 84-22-064 (Feb. 28, 1984) (37-acre farm).

38. Priv. Ltr. Rul. 87-11-054 (Dec. 15, 1986).

only a few large farm properties in the area remained undeveloped.³⁹ Both of the 1986 rulings emphasize the "uniqueness" of the property.⁴⁰

A late 1986 private letter ruling, on the other hand, seems to support the position that merely preserving farmland is enough.⁴¹ The ruling focuses not on the presence of any development in the area of the farm, but instead on the fact that the township ordinance favored the lessening of industrial, commercial and residential development in the immediate agricultural area. The ruling found the delineated governmental policy by focusing on state statutes identifying the preservation of farm land as a conservation goal and a township ordinance setting forth a policy favoring the preservation of open space and agricultural policy.⁴²

C. The Scope of the Deduction Allowed

1. Valuation of the Conservation Easement

Fair market value determines the amount of the deduction allowed for contribution of a conservation easement.⁴³ Since market-place sales of conservation easements are rare,⁴⁴ a donor usually values the contribution as the difference between the fair market value of the property it encumbers before and after the granting of the restriction. The regulations allow this valuation "as a general rule (but not necessarily in all cases)."⁴⁵

If before and after valuation is used, the fair market value of the property before contribution of the conservation restriction must take into account not only the current use of the property but also an objective assessment of how immediate or remote the likelihood is that the property, absent the restriction, would in fact be developed.⁴⁶ The valuation must also consider the effect of zoning, conservation, or other laws that already restrict the property's potential highest and best use.⁴⁷ The donor receives no income tax deduction if the property value is enhanced or unaffected by the easement.⁴⁸ If the easement allows some development, the valuation must consider the allowable development.⁴⁹

2. Limitations on the Deduction

The charitable contribution provided by the conservation easement may be deducted up to the amount of 30% of the donor's adjusted gross income in the tax

39. *Id.*

40. *Id.*; Priv. Ltr. Rul. 86-23-037 (Mar. 11, 1986).

41. Priv. Ltr. Rul. 87-13-016 (Dec. 23, 1986).

42. See *infra* part II.E.

43. Treas. Reg. § 1.170A-14(h) (as amended 1988).

44. The regulations indicate a preference for valuation based upon comparable sales in the market-place. *Id.* § 1.170A-14(h)(3)(i).

45. *Id.* § 1.170A-14(h)(3)(i).

46. *Id.* § 1.170A-14(h)(3)(ii).

47. *Id.*

48. *Id.*

49. *Id.*

year of the contribution.⁵⁰ Any unused portion of the deduction may be carried forward for up to five years.⁵¹ If the deduction is not used within that five-year period it is forever lost.

D. State Law

Common law fails to necessarily recognize conservation easements. "[I]t must not . . . be supposed that incidents of a novel kind can be devised and attached to property at the fancy or caprice of any owner. It is clearly inconvenient both to the science of law and the public weal, that such latitude should be given."⁵² Thus, states must enact laws to recognize conservation easements in order to ensure the viability of the conservation easement contribution.

For example, Virginia enacted the Open-Space Land Act in 1966,⁵³ prior to adoption of the federal legislation on conservation easements, which occurred in 1986. Among other items, the Act authorizes "any public body" to acquire perpetual easements designed to maintain the character of the land as open-space land.⁵⁴ Notably, the Virginia Open-Space Land Act places special emphasis on farming and timber use. In fact, the Act appears to allow only farming or timber on open-space land. This focus arguably allows a deductible conservation easement donation on land preserved "for farmland's sake" in Virginia.⁵⁵

At the same time, the Virginia General Assembly created the Virginia Outdoors Foundation.⁵⁶ The Act empowers the Virginia Outdoors Foundation to, *inter alia*, accept, hold, and administer gifts of any interest in real property.⁵⁷

After adoption of the federal regulations on conservation easements, the Virginia legislature clarified matters by enacting the Virginia Conservation Easement Act in 1988.⁵⁸ The Act defines "conservation easement" and details its creation, donation, acceptance and duration. As of 1990, Stockford found that more than forty states had enacted legislation sanctioning the granting of less-than-fee interest in property for conservation, scenic or historic purposes.⁵⁹

E. Estate Tax Benefits

Conservation easements may enable a property owner to reap estate tax benefits in two ways. First, the estate tax is usually levied on the fair market value of the property, not the value in its existing use. If the owner has restricted property use

50. I.R.C. § 170(G)(1)(C)(i) (1994).

51. *Id.* § 170(G)(1)(C)(ii).

52. Keppell v. Baily, 39 Eng. Rep. 1042, 1049 (Ch. 1834).

53. VA. CODE ANN. §§ 10.1-1700-10.1-1705 (Michie 1993).

54. *Id.* § 10.1-1703.

55. Priv. Ltr. Rul. 87-13-016 (Dec. 23, 1986), *see supra* part II.B.3., supports this position, as does Treas. Reg. § 1.170A-14(f), example 5 (as amended 1988).

56. VA. CODE ANN. §§ 10.1-1800-10.1-1804 (Michie 1993).

57. *Id.* § 10.1-1801.5.

58. *Id.* §§ 10.1-1009-10.1-1016.

59. Daniel C. Stockford, *Property Tax Assessment of Conservation Easements*, 17 B.C. ENVTL AFF. L. REV. 823, 824 (1990).

by a conservation easement before death, the property must be valued in the estate at the restricted value. Normally, this restricted value will be lower than the unrestricted value and will reduce the estate tax owed.

Each person possesses a \$192,600 unified credit toward estate and gift taxes. This entitles each person to gift, during life, at death, or a combination of both, up to \$600,000 worth of property without paying estate or gift taxes. If one donates a conservation easement on the property, they may then gift, either during life or at death, a larger amount of land under the unified credit.

A conservation easement also allows more efficient use of the \$10,000 annual gift tax exclusion. This exclusion allows each individual to give, during life, gifts valued at up to \$10,000 per donee per calendar year without paying gift tax and without counting toward the unified credit.⁶⁰ A conservation easement reduces the value of the land and thus allows more land to be given away under the exclusion. Similarly, a conservation easement increases the amount of land available for the \$500,000 per year per person intra-family installment sale qualifying for a reduced interest rate under section 483(e) of the Code.

Finally, the generation-skipping tax imposes tax on transfers which "skip" a generation (for example a grandparent gifting to a grandchild).⁶¹ However, one may gift up to \$1 million worth of property under an exemption from the generation-skipping tax.⁶² A conservation easement allows more property to come under this exemption also.

It should be noted that a property owner may also make a charitable gift of a conservation easement upon death, which would also be deducted from the estate. Consequently, this would reduce the value on which estate taxes are levied and result in a lower estate tax, just as a lifetime gift would reduce estate taxes.

F. Real Property Tax Benefits

Most, if not all, states allow localities to tax landowners based on the fair market value of their real estate. A conservation easement may lower the development potential of the property, decrease the assessment and thereby reduce the amount of the property taxes. However, states widely vary in their treatment of conservation easements for property tax evaluation purposes.⁶³ According to Stockford, as of 1990, more than half of the states that possessed conservation easement enabling legislation had provided by statute that the imposition of conservation restrictions shall affect the property tax evaluation of the burdened land.⁶⁴

For example, in Virginia, the law provides that if a conservation easement is perpetual, the holder of the conservation easement, the owner of the parcel, or a third party holding the right of enforcement shall not be taxed for real property

60. I.R.C. § 2503(G) (1988).

61. I.R.C. §§ 2601-2614 (1988 & Supp. V 1993).

62. *Id.* § 2631.

63. Stockford, *supra* note 60, at 826.

64. *Id.* at 830.

purposes.⁶⁵ Land which is subject to a perpetual conservation easement shall be assessed and taxed at its use value for open space, "if the land otherwise qualifies for such assessment at the time the easement is dedicated."⁶⁶ Once the land with the easement qualifies for the use assessment, it shall continue to qualify as long as the locality has land use assessment.⁶⁷

Several state court decisions across the United States also reflect the common sense notion that conservation restrictions lower the fair market valuation of the burdened land.⁶⁸ However, studies show a wide divergence in the amount of the reduction in valuation. One study in Massachusetts indicated a variation in assessment reductions from as little as 13% to as much as 95% of the property's value, prior to donation of the easement.⁶⁹ The Maine Coast Heritage Trust conducted a statistic analysis of thirty-six federal tax appraisals of conservation easement.⁷⁰ The study revealed that an easement resulted in reductions of fair market value between 5% and 90%.⁷¹

Federal tax cases also vary significantly in their rulings on the impact of conservation easements on the fair market value of the property. Although these federal cases value conservation easements for the purposes of the charitable contribution deduction, they may provide insights into valuation for real property tax purposes.

The tax court found in one case that a conservation easement had diminished the fair market value of the subject property by 75%, and in another case held that the easement decreased the market value by over 90%.⁷² However, the tax court held in two other cases that the conservation easement reduced the value of the conservation easement by only approximately one-third.⁷³

These widely varying results suggest that states without statutes specifying real property tax ramifications of conservation easements should adopt such statutes. States should provide assessors with some guidance on valuing land burdened with a conservation easement. The Tax Court appears ready to welcome similar guidance from Congress.

G. Practical Considerations

Once your client decides to make or consider making a donation of a conservation easement, the exact parameters of the restrictions and the exact acreage encompassed

65. VA. CODE ANN. § 10.1-1011 (Michie 1993).

66. *Id.*

67. *Id.*

68. *Id.* at 831.

69. Note, *Pursuing Open Space Preservation: The Massachusetts Conservation Restriction for Environmental Affairs* ENVTL. AFF. 481, 497 (1975).

70. MAINE COAST HERITAGE TRUST, TECHNICAL BULLETIN #104: CONSERVATION EASEMENTS AND PROPERTY TAXES 3-4 (Ctct. 1989).

71. *Id.*

72. *Stanley Works v. Commissioner*, 87 T.C. 389, 412-13 (1986); *Stotler v. Commissioner*, 53 T.C.M. (CCH) 973, 983 (1981).

73. *Symington v. Commissioner*, 87 T.C. 892 (1986); *Thayer v. Commissioner*, 36 T.C.M. (CCH) 1504 (1977).

by the restrictions must be determined. As in much of life and law, negotiation and compromise determine the final terms and conditions of the easement. The donee organization always reserves the right to decline any proffered donation. However, most donee organizations remain eager for donations, tempering this power of refusal. The degree of bargaining power held by the donor depends ultimately on the desirability of the particular tract for preservation.

First, one must determine whether the easement will cover all of the property or just a portion. The author knows of no state law which contains a minimum number of acres. However, the larger the tract, the more likely that the donee organization will accept the donation. Other factors, such as uniqueness of the property, historical significance of the property, development pressure from surrounding areas, and other factors determine whether a particular proffer of a conservation easement donation is acceptable to the donee organization. Attorneys should counsel their clients on the possibility of donating the easement on less than all of their property.

In addition, the specific restrictions contained in conservation easements come in as many variations as may vary as the properties they encumber. For example, one donor may have two children and one farm that she may wish to encumber with a conservation easement. If acceptable to the donee organization, the donor may carve out an exception which allows an additional house to be built on the property so that both children may live on the property.

If such a "carve out" is attempted, the drafter must ensure that any development is limited in type, scope and geographic area. Again, depending on the significance of the specific property, the potential donee organization may accept varying degrees of development restriction.

Because each property and situation is unique, no "cookbook" exists for the drafter to pull the appropriate terminology for insertion in the easement. Drafters must carefully and thoughtfully craft each word and phrase for clarity and precision. Although all drafters hope to anticipate each and every future possibility, inevitably unanticipated situations arise. Thus, the clarity must be balanced with flexibility so that future conditions can be accommodated. A drafter must remember that their words shall be reviewed and analyzed for hundreds, if not thousands, of years.

Finally, a drafter must also consider language limiting not only development but *use* of the property. An easement may allow any type of farm or forestry operation, or may limit the scope by imposing limits on, for example, the use of machinery or other inputs to the operation. Again, the competing interests of clarity and flexibility determine the language used to delineate allowable activities.

H. Conclusions

Conservation easements may provide useful federal income tax, estate tax and local real property tax benefits in proper situations. However, depending upon the extent of the value of the easement, many farmers and ranchers may not be able to utilize the full extent of the income tax benefits. Put simply, one must have income before one can take the advantage of the deduction. The law allows a taxpayer to deduct only 30% of his adjusted gross income each year for charitable contributions with a five-

year carry forward. Unless a farmer or rancher reports significant adjusted gross income, the deduction proves of little use.

Perhaps more importantly, conservation easements last forever. Property which may be suitable for farming and ranching at the time of the donation may at a later time prove to be inappropriate for those uses. A farm or ranch which is not profitable must continue into perpetuity. In addition, if large numbers of farms and ranches are subject to conservation easements, local governments may be strapped for funds, from reduced real property tax revenues. Local governments may increase the tax rate to compensate for reduced revenue.

Measuring the costs and benefits of conservation easements proves difficult.⁷⁴ Equity concerns also may arise as to who actually benefits from the easements and who bears the cost. In addition, problems of interpretation and application of easement language may arise, particularly when the easement has been in existence for a number of years.

III. Section 2032A Valuation

A. Introduction

Farmers and ranchers may also use section 2032A of the Code to reduce the value of their estate for estate tax purposes and, thus, reduce or eliminate estate taxes. Section 2032A of the Code allows an executor of an estate, in certain circumstances, to elect to value property at its use value as opposed to fair market value for estate tax purposes. A section 2032A election involves many technical and complex issues. This article provides only an overview. The author recommends a thorough reading of the statute and regulations for a deeper understanding. Section IV of this article uses examples to compare and contrast conservation easements and the section 2032A election.

B. General Requirements

Section 2032A of the Code allows an executor of an estate, in certain circumstances, to elect to value property at its use value for estate tax purposes, as opposed to fair market value. As a threshold matter, the decedent must (at the time of his death) have been a citizen or resident of the United States, and the executor must elect the application of the section and file a required agreement.⁷⁵ The aggregate decrease in the value of qualified real property with respect to any decedent may not exceed \$750,000.⁷⁶

"Qualified real property" means real property located in the United States which was acquired from or passed from the decedent to a qualified heir of the decedent.⁷⁷ The real property must have been used for a qualified use by the decedent or a

74. Quinn, *supra* note 30, at 264.

75. I.R.C. § 2032A(a)(1) (1988).

76. *Id.* § 2032A(a)(2).

77. *Id.* § 2032A(b)(1).

member of the decedent's family, on the date of the decedent's death.⁷⁸ "Qualified use" includes a farm or farming purposes.⁷⁹

To qualify, 50% or more of the adjusted value of the gross estate must consist of the adjusted value of real or personal property which on the date of the decedent's death, was being used for a qualified use by the decedent or a member of the decedent's family, and was acquired from or passed from the decedent to a qualified heir of the decedent.⁸⁰ In addition 25% or more of the adjusted value of the gross estate must consist of the adjusted value of real property which meets the other requirements of section 2032A of the Code.⁸¹

During the eight-year period ending on the date of the decedent's death there must have been periods aggregating five years or more during which the real property was owned by the decedent or a member of the decedent's family and used for a qualified use by the decedent or a member of the decedent's family, and there was material participation by the decedent or a member of the decedent's family in the operation of the farm or other business.⁸² Finally, the executor must designate the real property in the required agreement.⁸³

C. Material Participation

Actual employment of the decedent, or a member of the decedent's family, on a substantially full time basis (thirty-five hours a week or more), or to any lesser extent necessary to personally manage fully the farming business in which the real property is used, constitutes material participation.⁸⁴ If the participant is self employed, in the absence of direct involvement in the farm or ranch business, the regulations look to whether the participant's income is earned income for purposes of the tax on self-employment income.⁸⁵ The income must constitute earned income for material participation.

The regulations consider no single factor as determinative of the presence of material participation, but physical work and participation in management decisions constitute the principle factors to be considered.⁸⁶ If the property is owned by a corporation, partnership, or trust, an arrangement must exist calling for material participation in the business by the decedent owner or family member. Even full-time involvement must be pursuant to an arrangement specifying the services to be performed.⁸⁷

78. *Id.*

79. *Id.* § 2032A(b)(2).

80. *Id.* § 2032A(G)(1)(A).

81. *Id.* § 2032A(G)(1)(B).

82. *Id.* § 2032A(G)(1)(C).

83. *Id.* § 2032A(G)(1)(D).

84. Treas. Reg. § 20.2032A-3(e)(1) (as amended 1981).

85. *Id.*

86. *Id.* § 20.2032A-3(e)(2).

87. *Id.* § 20.2032A(f)(1).

D. Special Rules for Retired or Disabled Persons

Special rules apply to decedents who were retired or disabled at the time of death. In such a case, the material participation requirement applies with respect to such property by reference to the beginning date of the longest continuous period of material participation, as opposed to the date of death.

"Retired or disabled" means the decedent was, at the date of death was either: (1) receiving old-age benefits under title II of the Social Security Act for a continuous period ending on such date, or (2) was disabled for a continuous period ending on such date.⁸⁸ "Disabled" means possessing a mental or physical impairment which renders one unable to materially participate in the operation of the farm.⁸⁹

E. Special Rules for Property Acquired from a Spouse

Special rules also exist for property which the decedent acquired from a spouse. Active management of the farm by the surviving spouse shall be treated as material participation by that surviving spouse.⁹⁰ The surviving spouse shall not be treated as failing to use such property in a qualified use solely because such spouse rents such property to a member of the spouse's family on a net cash basis.⁹¹

The determination of whether property is qualified real property with respect to the first spouse to die shall be made without regard to the required agreement and without regard to whether an election was made.⁹² In any case in which to do so will enable the material participation requirements to be met with respect to the surviving spouse, the "qualified property" definition and recapture rules shall be applied by taking into account any application of the special retirement and disability rules.⁹³

F. Tax Treatment of Dispositions and Failures to Use for Qualified Use

1. Generally

If the qualified heir disposes of the property or ceases to use the property for a qualified use within ten years after the decedent's death and before the death of the qualified heir, the estate must pay an additional estate tax.⁹⁴ The amount of the additional tax imposed with respect to any interest disposed of or no longer qualified equals the lesser of: (i) the adjusted tax difference attributable to such interest, or (ii) the excess of the amount realized with respect to the interest (or,

88. I.R.C. § 2032A(G)(4)(A) (1988).

89. *Id.* § 2032A(G)(4)(B).

90. *Id.* § 2032A(G)(5)(A).

91. *Id.*

92. *Id.* § 2032A(G)(5)(B).

93. *Id.* § 2032A(G)(5)(C).

94. *Id.* § 2032A(C)(1).

in any case other than a sale or exchange at arm's length, the fair market value of the interest) over the value of the interest determined considering actual use.⁹⁵

The adjusted tax difference attributable to an interest equals the amount which bears the same ratio to the adjusted tax difference with respect to the estate as -- (i) the excess of the fair market value of such interest over the use value of such interest determined under section 2032A of the Code, bears to (ii) a similar excess determined for all qualified real property.⁹⁶

The term "adjusted tax difference with respect to the estate" means the excess of what would have been the estate tax liability but for the section 2032A election over the estate tax liability. The term "estate tax liability" means the tax imposed by section 2001 reduced by the credits allowable against such tax.

2. Partial Dispositions

Where the qualified heir disposes of a portion of the interest acquired by (or passing to) such heir or ceases to use such a portion, the value determined under the section 2032A election, taken into account for purposes of determining the additional tax with respect to such portion, shall be its pro rata share of such an interest. The adjusted tax difference attributable to the interest, taken into account with respect to the transaction involving the second or any succeeding portion, shall be reduced by the amount of the additional tax imposed, with respect to all prior transactions involving portions of the interest.⁹⁷

G. Interaction Between Section 2032A and Conservation Easements

Theoretically, one may elect section 2032A use value for property which is already subject to a conservation easement. If the easement allows some development, the election may allow further reduction in the fair market, given the further restriction of use for ten years following the election. If that is the case, the conservation easement will allow more land to be brought within the maximum \$750,000 reduction in value allowed under section 2032A of the Code.

Conversely, one may wish to donate a conservation easement on property subject to a section 2032A election. The author cautions that the fair market value of the donation may be reduced because of the restrictions under section 2032A. Specifically, as the uses are limited to agriculture for ten years even without the easement, the restrictions provided by the easement prove less valuable. When possible, the donation of the conservation easement should be delayed until after the ten year period if only for this purpose. However, Internal Revenue Service rulings, indicates that one should not donate a conservation easement on property subject to the section 2032A election in any case.

The author located two instances in which the Internal Revenue Service encountered the collision of a conservation easement and a section 2032A election. In Private Letter Ruling 8940011, the IRS ruled that the transfer of a perpetual

95. *Id.* § 2032A(C)(2)(A).

96. *Id.* § 2032A(C)(2)(B).

97. *Id.* § 2032A(C)(2)(D)(ii).

conservation easement on land, valued under section 2032A, constituted a disposition triggering the additional tax. This result held even though the easement was for charitable purposes and restricted the use of the land to agricultural purposes. The IRS failed to mention the number of acres affected by the easement.

On the other hand, in Private Letter Ruling 8946023, the IRS found that the sale of a conservation easement in nine acres of the three hundred fifty-four acre farm, valued under section 2032A, failed to constitute a disposition triggering the additional tax. In that case, the easement was for a limited time, but not less than ten years. The IRS held that the qualified use continued under the circumstances. Given the uncertainty caused by these rulings, farmers and ranchers should not risk granting a conservation easement on property subject to the section 2032A election.

IV. Examples

This example considers two different farm families. In each example, the farmer or rancher's situation is reviewed in an application of conservation easement and a section 2032A election is discussed.

Example 1:

Ted and his wife Jane are ranchers. Ted also owns a television station. Jane distributes self-improvement videos. Their combined annual adjusted gross income is approximately \$1.5 million. Their ranch in Wyoming is valued at \$3 million. They intend to maintain the property as a ranch for the rest of their lifetime. Ted and Jane have one daughter, Tina, whom he wishes to continue the ranch after his death. Tina seems totally uninterested in managing the operation. She prefers to party, and Ted and Jane fear she will sell the ranch for development and spend the money unwisely.

Ted and Jane should consider donating a conservation easement on the property. Assuming that the restrictions in the conservation easement would reduce the value of their property to \$1.5 million, they will now be able to deduct 30% of their adjusted gross income, or \$450,000, in the year that the donation, as well as the two years following the donation was made. In the third year following the donation, Ted and Jane can deduct \$150,000 for the contribution. Ted and Jane derive significant and immediate income tax benefits from the contribution.

Assuming Wyoming has a provision for use valuation for real property taxes, and the locality in which they reside allows that election, Ted and Jane will also be able to ensure use valuation of their property, saving local property taxes. Upon their death, the value of the estate will be reduced by \$1.5 million, resulting in significant estate tax benefits. They will also ensure that the ranch will remain in its natural state into perpetuity.

The executor of the estate may wish to consider a section 2032 election upon their death. If the conservation easement allows some limited development, a section 2032A election may further reduce estate taxes.

Example 2:

Paula and Peter Poor are beef cattle farmers in Nowhere, Virginia. When they purchased the farm in 1962, the land was valued at \$100 per acre, their purchase

price. Due to Nowhere's proximity to Capital City, Virginia, land prices have appreciated significantly. The farm is now worth \$1.5 million.

The Poors' adjusted gross income fluctuates, but is usually around \$30,000 per year. A conservation easement on the property would reduce the value of the property to \$750,000. The Poors have three children, one of whom seems interested in continuing the farm operation under her management when Paula is no longer able to manage the farm.

The Poors consider the donation of a conservation easement. However, they only would be able to use approximately \$54,000 of the \$750,000 value of the donation against their income taxes during the six year allowable period (30% of \$30,000 is \$9,000). Therefore, their income tax benefits are substantial, but not in relation to the value of her contribution. The contribution would reduce estate taxes significantly. However a section 2032A election would also reduce estate taxes in a similar, or perhaps, greater amount.

The Poors should forego donating a conservation easement and instead urge their executor to elect estate tax valuation of the property under section 2032A. The maximum reduction would allow them to take the entire \$750,000 reduction in value. Combined with other estate planning, they could reduce their estate tax to zero. Her daughter could operate and own the farm upon her death. If after the ten year period the farm is not profitable, the daughter could sell the land for development.

V. Other Provisions

A. Introduction

Other local, state, and federal provisions exist which offer income, estate or local tax benefits to farmers for conservation or environmental activities. This article does not attempt to list all such possibilities. However, this section briefly discusses several other tax benefits.

B. The Land Preparation Provision

Farms may capitalize normally deductible preproductive period expenses if this capital treatment provides a tax benefit.⁹⁸ Likewise, farmers may elect to deduct certain expenditures that normally are considered capital expenditures.⁹⁹

1. Fertilizer, Lime, and Soil Conditioning Expenditures

The benefits of fertilizer, lime and other soil conditioners usually last substantially more than one year. However, the farmer may elect to deduct these expenditures immediately rather than to capitalize them.¹⁰⁰ Section 180(a) of the Code provides that the taxpayer may deduct expenditures that are "paid or incurred

98. Treas. Reg. § 1.162-12 (1972).

99. See I.R.C. § 175 (1994) (soil and water conservation expenditures); I.R.C. § 180 (1994) (fertilizing expenditures).

100. NEIL HARL, AGRICULTURAL LAW § 28.04[1] (1981).

by him during the taxable year for the purchase or acquisition of fertilizer, lime, ground limestone, marl, or other material to enrich, neutralize or condition land used in farming."

2. Soil and Water Conservation

Farmers may elect to deduct soil and water conservation expenditures in the year incurred, rather than to capitalize them by adding these amounts to the cost basis of the land.¹⁰¹ Such expenditures would normally have to be capitalized since they increase the value of the property.¹⁰²

The regulations specify that the eligible expenditures include those "paid or incurred for the purposes of soil or water conservation in respect of land used in farming, or for the prevention of erosion of land use in farming, but only if such expenditures are made in the furtherance of the business of farming."¹⁰³ Specifically, the regulations allow conservation expenditures for: (a) the treatment or movement of earth, such as leveling, conditioning, grading, terracing, contour, furrowing, or restoration of soil fertility; (b) the construction, control, and protection of diversion channels, drainage ditches, irrigating ditches, earth and dams, water courses, outlets, and ponds; (c) the eradication of brush; and, (d) the planting of windbreaks.¹⁰⁴

Expenditures not eligible for the election include expenditures of a type that are subject to an allowance for depreciation, such as facilities made of pipe or tile, and for wooden, masonry metal or concrete dams.¹⁰⁵ The deductions under section 175 are limited to 35% of the farmer's "gross income derived from farming" and is defined in the regulations.¹⁰⁶ The taxpayer may carry over the excess of section 175 expenditures exceeding 25% of gross income from farming into succeeding taxable years indefinitely.¹⁰⁷ Furthermore, deductible soil and water conservation expenditures are limited to those incurred consistent with a conservation plan approved by the Soil Conservation Service of the United States Department of Agriculture.¹⁰⁸

C. Business Energy Conservation Credits

Farmers may also qualify for a 10% to 15% credit for investment in energy property, separate from an addition to the regular state income tax credit.

D. State Income Tax Credits

Some states provide income tax credit for investment and conservation property. For example, Virginia provides income tax credits in several situations for environ-

⁹ 101. I.R.C. § 175 (1994).

102. HARL, *supra* note 101, § 28.04[2].

103. Treas. Reg. § 1.175-2(a) (as amended 1994).

104. *Id.* § 1.175-2(a).

105. HARL, *supra* note 101, § 28.04[2].

106. I.R.C. § 175(b) (1994); Treas. Reg. § 1.175-5(a)(2) (as amended 1963).

107. HARL, *supra* note 101, § 28.04[2][d].

108. I.R.C. § 175(c)(3)(A)(i) (1994).

mental or conservation measures. First, Virginia allows a credit against income tax in an amount equaling 25% of all expenditures made for the purchase and installation of conservation tillage equipment used in agricultural production by the purchaser.¹⁰⁹ "Conservation tillage equipment" means a planter or drill commonly known as a "no till" planter or drill, designed to minimize the disturbance of the soil in planting crops, and includes such planters or drill which may be attached to equipment already owned by the taxpayer.¹¹⁰ The credit may not exceed \$2500 or the tax liability of the taxpayer.¹¹¹ If the credit exceeds the tax liability, the amount exceeding the tax liability may be carried forward for a credit against the income taxes of that individual in the next five taxable years, until the total amount of the tax credit has been taken.¹¹²

Virginia also allows a tax credit for the purchase of advanced technology pesticide and fertilizer application equipment.¹¹³ The taxpayer must be engaged in agricultural production for marketing and must have in place a nutrient management plan approved by the local Soil and Water Conservation District.¹¹⁴ The credit equals 25% of all expenditures made by the taxpayer for the purchase of equipment certified by the Virginia soil and Water Conservation Board as providing more precise pesticide and fertilizer application.¹¹⁵ Eligible equipment includes manure applicators, tramline adapters, sprayers for pesticide and liquid fertilizers, pneumatic fertilizer applicators, and monitors, computer regulators, and height adjustable booms for sprayers and liquid fertilizer applicators.¹¹⁶ The maximum credit allowed is \$3750 the taxpayer's tax liability, whichever is less, in the year of the purchase. If the credit exceeds the taxpayer's tax liability for that year, the credit can be carried over for five taxable years.

Finally, Virginia allows a credit against income tax or gross receipts tax in an amount equal to 10% of the deduction allowed under section 179A of the Code for purchases of clean fuel vehicles principally garaged in Virginia or certain refueling property placed in service in Virginia. In contrast, the author could locate *no* provisions in West Virginia allowing an income tax credit for conservation or environmental plans.

E. Conclusions

Many federal, state and local tax benefits exist which are considered more obscure than conservation easements or the section 2032A election. However, these benefits may total large amounts for particular farmers or ranchers.

Farmers and ranchers must retain competent legal and accounting advisors to ensure that they consider and take advantage of all possible benefits. The

109. VA. CODE ANN. § 58.1-334A (Michie 1993).

110. *Id.*

111. *Id.* § 58.1-334.B.

112. *Id.*

113. *Id.* § 58.1-337.

114. *Id.* § 58.1-337.A.

115. *Id.*

116. *Id.*

provisions of each state and each locality must be carefully examined to glean their unique possibilities.

VI. Conclusion

Conservation easements and the section 2032 election both offer the promise of significant tax benefits for preserving a farm or a ranch and its farm and ranch use. However, many of the benefits of conservation easements are a mere illusion for farmers not making significant income. Each situation must be examined and any decision should be made based upon the unique circumstances of the farmer or rancher. Many times, the section 2032A election provides equal or slightly lesser benefits, but places few restrictions on the farmer or rancher. If the income tax benefits may be reaped by the donor, or the donor is motivated by factors other than income tax benefits, conservation easements provide an excellent vehicle for preservation of farm and ranch land.

Other tax benefits exist under the Code and under state law and local ordinances. Each farmer must explore the options available with her advisors and determine which options yield the maximum tangible and intangible benefits for the farmers and ranchers.

APPENDIX: COMPARISON OF CONSERVATION EASEMENTS AND THE § 2032A ELECTION

	Estate Tax Benefits	Income Tax Benefits	Real Property Benefits	Advantages	Disadvantages
Conservation Easements	Reduces estate taxes by reducing the value of property, since development is restricted. No limit to benefit.	Charitable deduction in the amount of the reduction in property value. However, deduction limited to 30% of adjusted gross income. Can be carried forward for 5 years.	Should reduce real property tax by reducing fair market value of property. Most states have statute. Must examine state statute.	Preserves character of property in perpetuity. Potentially provides tax benefits at all levels. Provides potentially greatest tax benefits in the form of federal income tax deduction. No restrictions on active participation or qualified heirs.	Locks land into open space. May encounter difficulty in interpreting restriction as the years pass and times change. May benefit only "gentleman" farmers and ranchers since income tax deduction limited based on adjusted gross income. Some question as to whether "simply farming" is enough to qualify. Forever is a long time.
§ 2032A Election	Value of property reduced to <u>use</u> value, thereby reducing estate tax. Election may reduce value by no more than \$750,000.	None.	Most states allow use value assessment of real property tax purposes. Land under a § 2032 A election should qualify, thereby reducing real property tax. Must examine <u>state statute and local ordinances.</u>	Restriction on use limited to 10 years. After 10 years, free to use land as you choose. Farming already qualifies for benefits.	Locks land into use for 10 years. Estate tax benefits limited to reducing value by \$750,000 or less. No income tax benefits. Rules limit flexibility by severely limiting who can be left the farm. Decedents and heirs must be <u>active</u> participants in farm operations.

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